

California Fair Political Practices Commission

MEMORANDUM

To: Chairman Getman and Commissioners Downey, Knox, and Swanson

From: Holly B. Armstrong, Commission Staff Counsel
John W. Wallace, Assistant General Counsel
Luisa Menchaca, General Counsel

Re: *In re Hanko* (O-02-088), Treatment of Incentive Compensation under Section 87103(c)

Date: June 26, 2002

I. Introduction

Roger A. Brown's request for a formal opinion on behalf of one of the members of the Peninsula Health Care District's Board of Directors, Terilyn Hanko, came before the Commission for its first hearing at the Commission's meeting on June 7, 2002. At that meeting, the Commission directed staff to prepare a memorandum analyzing Director Hanko's position, taking into account the following factors: (1) Attribution; (2) Salary vs. Bonus or Commission; (3) Reconsideration of What Constitutes a Commission; (4) Public Official's Knowledge of the Source of Income; (5) Direct Contact vs. No Contact or Indirect Contact; and (6) Other Issues Raised in Roger Brown's June 3, 2002, Letter.

II. Facts

The District:

The Peninsula Health Care District ("District") is a local health care district organized under the provisions of the California Health and Safety Code §§ 32000 et seq. For more than a year, the District has been negotiating a contractual "restructured relationship" with Mills Peninsula Health System ("MPHS"), a wholly owned subsidiary (as that term might apply in the non-profit sector) of Sutter Health ("Sutter"). Both MPHS and Sutter are California non-profit public benefit corporations. MPHS is a local entity operating the San Mateo health system, which consists of the merged operations of Peninsula Hospital and Mills Hospital. Sutter is a large multi-hospital system. MPHS affiliated with Sutter in January 1996.

In 1985, the District entered into a 30-year lease of its hospital, Peninsula Hospital in Burlingame (the "Hospital"), with MPHS, pursuant to which MPHS operated the Hospital and the District became the landlord. In 1997, the District commenced litigation against MPHS, seeking to invalidate the lease based on circumstances underlying the negotiation and execution of the lease. In 1998, while the litigation was pending, seismic safety regulations were issued by the state implementing SB 1953, legislation enacted in 1995, mandating earthquake structural integrity standards for California hospitals. After each conducted independent engineering

studies, both the District and MPHS concluded that the Hospital would need to be replaced with a newly constructed facility. Recent amendments to the original legislation mandate replacement of the facility by the year 2013. The District and MPHS then began to negotiate a resolution of the issues created by SB 1953 and the lawsuit.

The negotiations between the District and MPHS were aimed toward a global settlement of the litigation by which MPHS (assisted with financing from Sutter) would construct and operate a new hospital on land leased from the District, subject to terms guaranteeing specified community benefits and granting the District certain oversight responsibilities. In August of 2000, the District, MPHS, and Sutter approved a Letter of Intent incorporating preliminary terms of a global settlement, including dismissal of the District's lawsuit. The District and MPHS are currently negotiating what would be final contractual terms of the "restructured relationship." If the District, MPHS, and Sutter reach final contractual terms, the terms of the "restructured relationship" will be placed on an upcoming ballot for approval or disapproval by voters residing in the District.

The District's board of directors, including Director Hanko, will be called upon to give direction to the District's negotiators, including voting on certain agreements to be incorporated in the final deal, and to ultimately vote to approve or disapprove the final agreements with MPHS, which will likely include Sutter as a signatory to the main or ancillary agreements. Final approval will also encompass the dismissal of the pending litigation.

Director Hanko and Baxter:

Director Hanko was elected to the District board for the first time in November of 2000. Director Hanko is employed by Baxter Healthcare Corporation, a Fortune 500 company conducting business worldwide in pharmaceutical and healthcare supplies. She also owns stock that has a value in excess of \$2,000. Director Hanko is a "pharmaceutical products specialist" for Baxter. Her duties consist mainly of marketing certain Baxter pharmaceutical products to healthcare providers, including hospitals, long term care providers, surgery centers, and other health services providers. Her efforts on behalf of Baxter are focused on educating healthcare professionals in these various settings about Baxter products available to them, including product introductions and follow-up utilization and general information about the use of the products. Therefore, her representation of Baxter encompasses pre- and post-sales presentations. Director Hanko does not "take orders" or conduct actual sales transactions. Healthcare providers purchase Baxter products through independent specialty wholesale companies with whom the providers conduct orders and purchase transactions. The wholesale companies purchase and resell the Baxter products to these providers. MPHS purchases Baxter products in this manner. During calendar year 2000, MPHS purchases of Baxter products through the wholesale companies amounted to approximately \$387,400.

In addition to the salary from and investment in Baxter, her employer also provides a bonus payment based on overall sales of Baxter products within Ms. Hanko's territory. The company annually establishes budgets for projected sales of product groups within a territory. It

then creates a formula based on a target that is a percentage of projected total sales for a representative's product group and territory. The target (e.g., 85% of projected gross sales for the calendar year) becomes a minimum threshold of overall product sales in the territory before any incentive income will be paid. If, during the year, the overall sales of the product group exceed the targeted percentage of projected sales, the representative may receive incentive compensation that increases with the amount of overall sales exceeding the minimum threshold target of gross sales. The budget and target sales formulas do not take into consideration any individual efforts by Director Hanko as a Baxter representative. The company cannot trace individual product sales to its representatives. Therefore, the budget and target sales formulas are based entirely on product gross sales performance.

The company reserves the right to, and occasionally does, change its projected sales budgets and threshold targets during the course of a year based on its evaluation of the company's health and changing market conditions. Likewise, the company reserves the right to cancel the incentive compensation program altogether, and employee representatives must acknowledge in writing that the incentive program creates no express or implied contractual right to extra compensation.

Baxter employs consultants who conduct regular surveys of Baxter product sales through the independent wholesalers that conduct actual orders and sales with providers, such as hospitals. Baxter can determine from these consultants the approximate gross sales of its products to individual purchasers. These estimates are approximate because of the method of data collection employed by the sales survey consultants. It is nevertheless possible to determine the approximate percentage of overall product sales in a given territory that are attributable to sales to a specific customer. In this manner, Director Hanko can estimate the percentage of overall Baxter sales in her coverage territory attributable to MPHS purchases at Peninsula and Mills hospitals. Based on the year 2000 incentive compensation she received, Director Hanko estimates that approximately \$1,000 of her total incentive compensation from Baxter could be attributed to MPHS purchases of Baxter products in 2000. It is likely (she has not made this calculation) that a somewhat larger amount of her year 2000 incentive compensation could be attributed to purchases of Baxter products by other Sutter-affiliated facilities in her coverage territory.¹

III. Analysis

The Commission has requested that staff further analyze Director Hanko's potential conflicts of interest for purposes of Government Code sections 87100 and 87103,² taking into account certain specific issues, which are addressed below.

¹ We have requested information pertaining to Director Hanko's total year 2000 incentive compensation, so that we can determine the proportion represented by the portion attributed to MPHS. However, Director Hanko declined to provide this information. This information would be relevant in the context of an indirectly involved economic interest in doing the eight-step conflict of interest analysis.

² All further statutory references are to the Government Code, unless otherwise specified.

The question addressed in this memorandum is whether certain payments to Director Hanko from her employer should be attributed to a customer of the employer, where Director Hanko has directed sales and marketing activity toward the customer and there is a direct relationship between the purchasing activity of the customer and the amount of the incentive compensation.

Based on the analysis of the issues addressed below, staff recommends the Commission find the following: Payments from Baxter, her employer, to Director Hanko will be attributed to MPHS, a customer of her employer, because Director Hanko: 1) has purposefully directed sales or marketing activity toward the customer; 2) there is direct contact between Director Hanko and the customer intended by Director Hanko to generate sales or business; and 3) there is a direct relationship between the purchasing activity of the customer and the amount of the incentive compensation received by Director Hanko. If these requirements are met, both the customer and the employer should be considered sources of income to an official for purposes of sections 87100 and 87103.³

A. Attribution

One of the issues considered by the Commission at its June meeting was whether Director Hanko should be required to attribute her incentive compensation⁴ to MPHS, which is one step removed from Director Hanko's employer in the retail chain, i.e. the "customer-of-a-customer." This concept of third-party attribution is found elsewhere in the Act, such as in the context of parent/subsidiaries and otherwise related business entities, which involve situations in which one business entity has a controlling ownership interest in the other, where there is shared management and control between the entities, or where a controlling owner in one entity is also a

³ There may also be disclosure implications under Government Code section 87207. However, there have been situations in which the Commission has determined that it was necessary to pierce the first layer to find that a public official had an economic interest in a third party, but has not required disclosure under 87207. For example, in *In re Nord*, (1983) 8 FPPC Ops. 6, the Commission found that a public official who was a limited partner had an economic interest in not only his controlling general partners, but also in "any other business entity in which either Smith or Jones or both act as a controlling general partner or controlling shareholder" Thus, the Commission said, disqualification was required in those cases. However, the Commission did not require that the public official disclose such third parties as sources of income. Likewise, in the *Dorsey* Advice Letter, No. A-87-176, the public official was employed by a temporary employment agency, in which capacity she worked for a corporation involved in a proceeding before her agency. Staff advised that both the temporary employment agency and the corporation to whom she was assigned to work were sources of income to her, and that she must, accordingly, disqualify herself from voting on the a matter that would have a material financial effect on the company for which she was performing services on temporary assignment. However, there was no commensurate disclosure instruction given. Therefore, the Commission need not address the disclosure issue at this time, if it should choose not to do so.

⁴ In staff's initial memorandum to the Commission, we referred to Director Hanko's additional compensation as a "bonus." Director Hanko's company, Baxter Healthcare Corporation refers to such compensation as "commissions." In her testimony to the Commission at the June meeting, Director Hanko, herself, referred to it as "incentive compensation." Because the type of compensation presented here appears to differ from both the traditional bonus and commission compensation structures, we adopted Director Hanko's label of "incentive compensation" as the most appropriate, and that phrase is used throughout this memorandum.

controlling owner in the other entity. (Reg. 18703.1.) None of these situations, however, applies to MPHS and Baxter.

The defining principle regarding attribution here should be: *Where a public official's sales or marketing activity is purposefully directed toward a business entity such that there is a direct relationship between the purchasing activity of the entity and the amount of the incentive compensation the official receives, then the person will be a source of income to the public official.*

"Incentive compensation" can be defined as an additional sum of money to be paid, over and above a base salary, solely based on results achieved by the individual as a product of his or her efforts, typically measured against pre-determined goals set by the employer. It differs from "commission" in that it is not based on a specific sale or similar transaction, and differs from a "bonus" in that it is not a singular event, but is ongoing and/or cumulative as sales or purchases accumulate. Thus, the incentive income, like a commission, is ultimately determined based on the conduct of the customer in direct response to the efforts of the public official.

The facts in this case are a compelling illustration.

(a) Director Hanko markets Baxter products directly to MPHS, both before and after they purchase Baxter products.⁵ There is clearly a direct salesperson/customer relationship between Director Hanko and MPHS.

(b) Purchases are made through an intermediary/wholesaler. This does not dilute the salesperson/customer relationship between Director Hanko and MPHS. Baxter employs Director Hanko to market its products to MPHS and other clients in her region. It does not employ her to market to the intermediary wholesalers. Were MPHS to discontinue using Baxter products, it is reasonable to assume that there would be a decline in Baxter's sales directly attributable to the loss of MPHS as a purchaser. No one has asserted this is not the case.

(c) Based on the success or failure of Ms. Hanko in this direct salesperson/customer relationship between Director Hanko and MPHS, a bonus is generated. Were MPHS to stop purchasing Baxter products, Director Hanko's bonus would be reduced proportionately. Were MPHS to purchase twice as many Baxter products (due to new construction or new patients), Director Hanko's bonus would increase accordingly. Director Hanko's efforts toward MPHS resulted in her receiving an annual incentive compensation of approximately \$1,000⁶ that can be traced directly to sales to or purchases of MPHS, according to Director Hanko.

⁵ According to her testimony before the Commission, part of her job is to keep hospitals that have purchasing contracts with Baxter compliant with their contracts and, if there is no contract in place, to try to initiate one. These contracts are to purchase certain amounts of Baxter products which, presumably, are still purchased through their wholesale dealers. We have been informed that MPHS does not have a current contract with Baxter.

⁶ The threshold amount for there to be an economic interest in a source of income under Govt. Code § 87103(c) and regulation 18703.3 is \$500 or more within 12 months prior to the decision.

It is not unlike the relationship of an individual purchasing an appliance at Sears. The appliance is purchased at Sears, but the warranty is registered with Maytag, and over the next ten years, Maytag continues to send the individual notices thanking them for being a loyal customer and offering to extend the warranty on the appliance for a fee. Even though the appliance was purchased at Sears, the purchaser is still a Maytag customer. Further, with every Maytag washer sold by Sears, presumably an additional Maytag washer is purchased from Maytag by Sears to replenish its stock of washers.

At its June meeting, the Commission asked if an associate at a law firm receiving a bonus at the end of the year based on billable hours or bringing business to the firm would be subject to this same rule.

In the case of an associate working billable hours, in most cases the associate's activity would not be "purposefully directed" toward a client in order to increase the number of billable hours. Although increasing the total number of billable hours could result in a bonus to an associate, a client is unlikely to willingly incur additional expenses in connection with his or her case; i.e. engage in purchasing activity as a result of the associate's legal work. Therefore, simply performing legal services would not, by itself, create a salesperson/customer relationship.

However, the situation in which the associate received a bonus as a direct result of attracting a client to the law firm as "new business" would be a different matter because it is a marketing activity. In that situation, the associate's activity would have been purposefully directed toward the client with an eye to bringing him or her to the firm, and there would be a direct relationship between the associate's success with the client and the amount of the incentive compensation the associate receives, the compensation having been awarded as a direct result of the associate's success or failure in enticing the new client to give business to the firm.

Indeed, the various advice letters dealing with law firm compensation and bonus structures vary widely from firm to firm such that it is difficult to reach any all-inclusive conclusion. For example, the *Hentschke* Advice Letter, No. I-92-660, dealt with a city council member who was employed as an attorney by a law firm, but was not a partner. Her compensation was unique among the lawyers in the firm. Whereas the other associates received a salary plus a potential bonus from firm profits, she was compensated based upon a percentage of the gross income received solely from her billings. Although she was guaranteed a base salary, the compensation based upon the percentage of the gross income from her billings had always been more than the base salary. She took no share from the profits of the firm. Based on these facts, we advised that, for both disclosure and disqualification purposes, both the firm and the clients were sources of income to the public official, because they were jointly responsible for the income she received. However, these appear to be unique facts based on the contract negotiated between this attorney and the firm. This type of situation was not analyzed as incentive compensation.

Two other letters found that only an employer was the source of income of a bonus payment. In the *Kohn* Advice Letter, No. A-94-378, the partner owned a less than 10 percent

interest in the firm. He was paid a fixed annual salary and was eligible for a bonus, the payment and amount of which was at the complete discretion of the managing partner. Whether a bonus was paid depended on the firm's profitability. If a bonus was paid, there was no correlation between the amount of the bonus and collections or billings with respect to any particular client. In the *Boyle* Advice Letter, No. A-97-239, the public official was a "non-equity partner," which meant he had no ownership interest in the partnership, which was organized as a corporation. He had "partnership points," which amounted to less than 5 percent of the total points owned by all partners in the firm, and his share of points determined the amount of his salary and bonus. At some time in the future, he would accumulate sufficient points to gain an ownership interest in the firm.

These letters demonstrate the variety of compensation structures that can be presented, and the difficulty in attempting to formulate a rule to deal with every situation prophylactically. These situations may be better addressed by advice letter on a case-by-case basis as they arise. However, it is safe to say that in most traditional law firm employment contracts (such as where an associate attorney receives an annual bonus based on hours billed), attributing income to the clients of the law firm would not be appropriate. This would be the case even where the associate can readily identify for which client the associate worked those bonus hours. These facts differ dramatically from the salesperson/customer relationship that exists in the Hanko situation and therefore would not be impacted by the decision in this case.

B. Salary vs. Bonus or Commission

If the Commission issues an opinion in which Director Hanko would be required to attribute her incentive compensation to MPHS as a source of income, a concern has been raised that she would likewise be required to apportion her *salary* among her clients and that her clients would be the sources of that income.

This conclusion is not suggested in the advice letters in question. Typically, salary is a guaranteed payment to an employee of a pre-set sum of money to perform the tasks of the job to which he or she is assigned, regardless of the effort put forth by the individual, or the quality or outcome of the work performed. This amount does not vary based on the employee's actions or those of the employer's clients. This is purely a contractual arrangement between an employer and employee. This has always been our advice in the past when dealing with salary.

As noted above, "incentive compensation" is an additional sum of money to be paid, over and above a base salary, solely based on results achieved by the individual as a product of his or her efforts, typically measured against pre-determined goals set by the employer. It differs from a "commission" in that it is not based on a specific sale or similar transaction, and differs from a "bonus" in that it is not a singular event, but is ongoing and/or cumulative as sales or purchases accumulate.

Nothing in the definition of bonus requires attribution beyond the employer in all cases. Thus, this further narrows the scope of the analysis. Not only would salary not be attributed to

clients, but not all bonuses would be attributable to clients. For example, an official working in a widget factory receives a bonus if he produces 100 more widgets a month. This is the case irrespective of who buys the widgets, his bonus arrangement would not call for attribution of any sort.

In Director Hanko's case, her incentive compensation was "based on measure of sales performance or activity as defined by Sales Management." (2000 Commission Policies and Procedures, IV Systems Division (attached as Appendix A).) The amount of incentive compensation is directly related to the effort put forth toward particular clients, and at least in certain cases, such as the one presented here, specific amounts of incentive compensation can be traced directly to sales to or purchases made by specific clients. Accordingly, the specific clients are easily identifiable as the sources of the additional income, over and above the base salary, received by Director Hanko's incentive compensation.

C. Reconsideration of What Constitutes a Commission

Based on the concept of "incentive compensation" as presented above, it is not necessary to reconsider what constitutes a commission, as the current definition of "commission" in regulation 18703.3(c) serves the purpose of defining a different form of compensation. There are certain commission structures, such as a "straight commission," that might not fit within the "incentive compensation" definition, and therefore, we feel that there is utility to retaining the current definition of "commission," while adopting the "incentive compensation" scheme, as well. However, in the future the commission income regulation could be broadened to apply to other types of incentive programs and other situations where attribution may be appropriate.

D. Public Official's Knowledge of the Source of Income

The public official's knowledge of the source of income was a critical element of the concept of incentive compensation in the *Coffey* and *Brown* Advice Letters, Nos. A-01-064 and A-01-286, respectively, because it is the public official's purposefully directed activity toward the person that sets incentive compensation apart from an otherwise standard bonus situation that is not tied to any particular client or specific activity on the part of the public official.

E. Direct Contact vs. No Contact or Indirect Contact

Likewise, direct contact was important in staff's analysis because the issue raised by these facts is the link between Director Hanko's efforts toward MPHS and her receipt of incentive compensation based on her employer's sales to MPHS (through wholesalers) that exceeded the threshold of \$500. It was suggested at the Commission meeting that a conflict of interest might still exist if Director Hanko were to receive incentive compensation based on the efforts of her entire team with no personal contact between MPHS and Director Hanko herself. Staff submits that this would not be incentive compensation attributable to a particular customer. Such compensation would simply be treated as income for which the employer was the source. Further, these are not the facts presented in the situation presented to the Commission in Director

Hanko's opinion request. In the present situation, the incentive exists in that Director Hanko has the opportunity to increase the amount of the compensation through her efforts and her relationship with MPHS. Director Hanko's employer apparently assumes that sales to MPHS can be increased through her efforts and, therefore, pays her additional compensation for performing her job well with respect to that particular client. Therefore, direct contact with the person to whom the incentive compensation is attributed is important.

F. Miscellaneous Issues Raised in Roger Brown's June 3, 2002, Letter

Mr. Brown raises additional arguments. They arise from regulation 18703.3(a), which states:

"A public official has an economic interest in any person from whom he/she has received income aggregating five hundred dollars (\$500) within 12 months prior to the time when the relevant governmental decision is made. For purposes of the Political Reform Act, a public official's income includes income which has been promised to the public official but not yet received by him or her, if he or she has a legally enforceable right to the promised income."

Mr. Brown contends first that staff was remiss in its initial memorandum for failing to analyze this subdivision of the regulation, because this subdivision, by using the language that a "public official has an economic interest *in any person from whom he/she has received income*," clearly means that he or she has an economic interest in the "actual payor." In its initial memorandum, staff provided an extensive analysis of the underlying statutes, Government Code sections 87103(c), 87103.5 and 87103.6 concluding that, under the rules of statutory construction, a third party, under the appropriate circumstances, can be a source of income within the meaning of section 87103(c). (See pgs. 7-10 of staff's Commission memorandum dated May 24, 2002, prepared for the June meeting, for the entirety of this analysis.)

Mr. Brown also asserts that because Baxter retains the right to cancel its incentive compensation program at any given time, Director Hanko has no "legally enforceable right" to receive it, which is required under regulation 18703.3(a). However, in this case, we are dealing with incentive compensation that was received in 2000. Thus, there is no need to speculate as to whether or not she will receive the incentive compensation. It has already been paid to her. "A public official has an economic interest in any person *from whom he/she has received income* . . ." (Reg. 18703.3(a).) Income already paid creates an economic interest as surely as promised income.

In addition, Mr. Brown asserts that staff's memorandum addressed the wrong question. Staff has focused the question directly on the relationship between Director Hanko and MPHS and whether that relationship gives rise to an economic relationship which, in turn, could give

rise to a potential disqualifying conflict of interest. This is the central issue before the Commission in this opinion request.

IV. Recommendation

We recommend that the Commission issue an opinion adopting the incentive compensation analysis set forth above and based on that principle, concluding that Director Hanko has a conflict of interest with respect to decisions concerning MPHS as long as she receives incentive compensation equal to or exceeding \$500 that can be traced to purchases of Baxter products made by MPHS.⁷ For future guidance, the following factors should be considered in making this determination. Incentive compensation to Director Hanko from her employer will be attributed to a customer of her employer in situations in which Director Hanko: 1) has purposefully directed sales or marketing activity toward the customer; 2) there is direct contact between Director Hanko and the customer intended by Director Hanko to generate sales or business; and 3) there is a direct relationship between the purchasing activity of the customer and the amount of the incentive compensation received by the public official. If these requirements are met, both the customer and the employer will be considered sources of income to an official for purposes of sections 87100 and 87103.

In the alternative, we recommend that the Commission allow the *Coffey* Advice Letter, No. A-01-064, and the *Brown* Advice Letter, No. A-01-286, to stand, and direct staff to place this issue on next year's regulation calendar for further definition and clarification of the incentive compensation principle.

Attachment

Hanko Performance Bonus Plan

⁷ We have received several comment letters in support of Director Hanko's participation in the negotiations and voting regarding the contract between the Peninsula Healthcare District and MPHS for the new hospital lease. These letters are being made available to the public through the FPPC's website, www.fppc.ca.gov.